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FM AMEMBASSY ULAANBAATAR  
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INFO AMEMBASSY SEOUL  
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UNCLAS ULAANBAATAR 000340

STATE FOR EAP/CM AND EB/IEC  
STATE PASS USTR, EXIM, OPIC, AND EPA  
STATE PASS AID/ANE D. WINSTON  
MILLENNIUM CHALLENGE CORP WASHDC FOR F. REID  
TREASURY PASS USEDST TO IMF, WORLD BANK  
MANILA AND LONDON FOR USEDST TO ADB, EBRD

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SUBJECT: June Elections Could Jeopardize Recent Reforms of  
Mongolia's Creaking Energy Sector

REF: A) ULAANBAATAR 0169, B) 07 ULAANBAATAR 0426 AND 0427

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1.(SBU) SUMMARY: In what amounts to a major breakthrough for donor-agency efforts to promote reform of Mongolia's deteriorated energy sector, Government of Mongolian (GOM) reps have for the first time publicly conceded that the sector is financially bankrupt and in wretched shape. The impetus for these statements and for the organization was provided by USAID and the Economic Policy Reform and Competitiveness Project (EPRC) starting in April 2007. Since that time, eight monthly meetings of the GOM/donor Energy Working Group (EWG) have been held and discussions of critical issues and problems facing the sector have been handled openly and candidly. The new Minister of Fuel and Energy (MoFE) has expressed support for the reform initiatives outlined and promoted by USAID/EPRC starting about two years ago and the EWG is in concurrence. The Energy Working Group (EWG) is a coalition of donor reps (USAID, ADB, World Bank, EBRD and GTZ) and GOM stockholders and stakeholders including the MoFE, the State Property Committee (SPC), the Ministry of Finance (MoF) and Energy Regulatory Authority (ERA). The EWG has continually encouraged closer cooperation between the EWG and the various GOM organizations on such issues as the need for an increase in coal prices and the methodology to determine appropriate prices; the need for a significant and immediate increase in both electricity and heat tariffs; the need for the MoFE to encourage the execution of Performance Agreements, a form of incentive regulation, between the ERA and the three largest energy enterprises; increased collaboration and integration of the ERA and MoFE; and the first steps toward building a new and badly needed large Combined Heat and Power Plant (CHP). The momentum gained in recent months slowed when politicians abandoned Ulaanbaatar to campaign in their districts ahead of the June 29 Parliamentary elections. Continuation (or possible curtailment) of the process depends heavily on the yet-to-be-announced results of the June 29 parliamentary election.  
END SUMMARY.

The Energy Sector is Bankrupt

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12. (SBU) Since April 2006 the Energy Working Group of donor organizations and GOM energy sector stakeholders, brought to life thanks primarily to the efforts of USAID Mongolia, has been pushing the GOM to implement desperately needed reforms to prevent the sector from certain electricity and heat shortfalls within the next one to two years. (See reftels for the state of the crisis.) Yet as late as December 2007 politicians have blocked all attempts by the ERA to significantly increase tariffs and EWG entreaties to fund large sectoral subsidies from the state budget rather than placing the burden on the energy companies, as is now the case has been ignored. The former Minister of Fuel and Energy (February to December 2007) saw no (self-) interest in increasing energy tariffs and in fact made outrageous and false statements on radio, TV and in the print media that tariffs would be going down.

#### FIRST STEP: ADMITTING YOU HAVE A PROBLEM

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13. (SBU) Things began to change in December 2007 when Ch. Khurelbaatar, former State Secretary in the Ministry of Finance and former Director of Mongolia's Millennium Challenge Account National Council, became Minister of Fuel and Energy in Prime Minister S. Bayar's government. Khurelbaatar immediately recognized the decrepit state of Mongolia's energy sector and signaled his desire to implement USAID/EPRC and EWG recommendations. In January, he publicly announced that the energy sector, so vital to Mongolia's economic development and national security, was bankrupt. The Minister of Finance and the former Prime Minister followed suit at the very same meeting. On January 29 the MoFE and the ERA signed a memorandum of understanding, based on language from the USAID contractor EPRC, which laid out common strategies and objectives. For the very first time in the energy sector, the Ministry and the ERA were collaborating on energy matters, and continue to do so.

#### First steps taken for Tariff Reform

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14. (SBU) The EPRC, a key member and driving force in the EWG, presented its retail tariff reform plan to the ERA and received their concurrence. The Plan will be distributed to other stakeholders, including the EWG, in mid June for review, comment and discussion. First proposed to the ERA in 2006, the two-part generation tariff methodology, separating tariffs on the fixed (capacity) and variable (energy) costs involved in energy generation, became effective on May 1. Next steps include the introduction of incentive-based regulation and economic dispatching of electricity and heat (a process of allocating the required load demand between the available generation units based on the lowest operating costs first), so that the cost of operation is minimized, less coal is consumed again reducing costs and also air pollution and creating the incentive for higher cost producers to reduce their costs. Consequently, system efficiency will be improved. Transmission and distribution tariffs will also be subject to incentive regulation.

#### Performance Agreements gaining momentum

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15. (SBU) With EPRC guidance first, and later with EWG guidance, the ERA established Performance Agreements (PA) with three of the 18 Central Energy System licensees. PA's create incentives for licensees to improve efficiency and lower costs with the prospect of obtaining monetary rewards for good performance. The ERA uses financial ratios, and in some cases technical and operational benchmarks, to track and reward the performance of licensees. Examples of financial ratios used include: liquidity ratios; profitability ratios and capital structure ratios. In a sign that the ERA's strategy appears to be working, the ERA finalized terms of a third PA for 2008 with the Erdenet-Bulgan Electricity Distribution Network. Negotiations continue with CHP #4 and other major energy companies.

#### Coal Prices and CHP #5

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16. (SBU) Effective December 1st, 2007, the government sanctioned price at which the privately-owned Sharyn Gol Coal Mine (SG) must

sell coal to Mongolian power plants increased from 13,600 to 16,600 Tugruks (about \$11 to \$15) per ton. Coal prices of the two other coal mines supplying the energy sector, where the GoM is the principal owner, were also increased but the increase was far less than SG. The move was crucial to keeping the coal mine solvent. Following long-standing recommendations of the EPRC and later the EWG, Minister Khurelbaatar has made building a fourth combined heating and power (CHP) plant in Ulaanbaatar (CHP #5) a top priority. The tender announcement was scheduled for May 20th, with bid submittals required 90 days thereafter. Unfortunately, the date has passed without an announcement and upcoming elections effectively guarantee that no further actions will take place until at least late summer.

#### Public Information/Public Education (PI/PE) Campaign

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17. (SBU) Energy sector reform efforts have suffered from a traditional lack of public discussion and awareness of the subject, and the negative public reaction towards proposed tariff increases has not helped. Since mid-2007 EPRC has been engaging journalists and the media with energy sector entities such as power plants, an electricity distribution company, the heat distribution and supply company and a coal mine and has made great strides distributing information in the past six months. There has been at least one television slot, one radio show, and numerous print articles aired after each of the six workshops held so far, with more to come. The campaign has educated the media and increased public awareness of the problems facing the energy sector. The EWG is fully briefed on the PI/PE campaign status, progress and plans at every EWG meeting.

#### Uncertainty amid summer elections

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18. (SBU) While some positive steps have been taken towards much needed reforms in the energy sector, more remains to be done. Upcoming June elections have the potential to threaten to jeopardize the EWG's new-found momentum, but the situation could also improve even further. There will be one more EWG meeting in late June and then all meetings will be suspended until the new government is formed. There is some concern that election results could yield a new political landscape less accepting of EWG initiatives. Already some politicians are suggesting that the MoFE (along with the Ministry of Roads, Transport and Tourism, among others) be rolled into an all encompassing Ministry of Infrastructure. This move has the potential to diminish the MoFE's and the EWG's influence on energy matters and add yet another layer of bureaucracy to a sector already burdened by excessive government involvement. On the other hand, if the new head of the energy sector (in whatever form) has the desire to continue to tackle the critical issues and problems facing the sector that will be yet another breath of fresh air, such as Minister Khurelbaatar provided when he was appointed.

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